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SUBJECT: CENTRAL BANK FIGHTS TO LIMIT CREDIT GROWTH

1. Summary: THE NATIONAL BANK OF SERBIA IS CAUGHT BETWEEN TWO CONFLICTING GOALS: PREVENTING DINAR APPRECIATION, WHICH IT PURSUES BY SELLING DINAR TO BUY UP FOREIGN CURRENCY, AND CURBING THE INFLATIONARY PRESSURE IT CREATES IN THE FIRST STEP. THIS BALANCING ACT HAS PROVED DIFFICULT, AS IT HAS IN OTHER TRANSITION COUNTRIES HIT BY SURGING CAPITAL INFLOWS, WITH INFLATION OF 17.7 PERCENT IN 2005 AND REAL APPRECIATION OF THE DINAR BY 9.6 PERCENT. WHILE THE CENTRAL BANK'S POLICY OF PEGGING THE DINAR HELPED TO REDUCE THE CURRENT ACCOUNT DEFICIT TO 8.6 PERCENT OF GDP IN 2005, KEEPING CREDIT GROWTH IN CHECK HAS PROVEN MORE AND MORE DIFFICULT, WITH THE HIGH LEVEL OF EUROIZATION WEAKENING THE EFFECTIVENESS OF MONETARY POLICY. THE CENTRAL BANK FURTHER TIGHTENED THE MONEY SUPPLY ON MARCH 31, AND IT WARNED OF MORE RESTRICTIONS TO COME. END SUMMARY.

MONEY SUPPLY RISES ON CAPITAL INFLOWS, REMONETIZATION

2. THE NATIONAL BANK OF SERBIA (NBS) IS FEELING THE PAIN OF PROSPERITY. RENEWED CONFIDENCE IN A BANKING SECTOR THAT IS NOW DOMINATED BY FOREIGN BANKS HAS LED TO REMONETIZATION, WITH EURO DEPOSITS UP BY 50.6 PERCENT IN 2005. DRIVEN BY THE CENTRAL BANK'S POLICY OF BUYING EURO FROM EXCHANGE HOUSES WITHOUT LIMIT, ITS GROSS RESERVES NOW TOP USD 6.1 BILLION, OR SEVEN MONTHS OF IMPORT COVER. RESERVE MONEY INCREASED BY 66.9 PERCENT IN 2005, THE NOMINAL RATE OF GROWTH OF M1 REACHED 30.2 PERCENT, AND M3, WHICH INCLUDES HARD CURRENCY DEPOSITS, WAS UP 41.9 PERCENT.

3. FOREIGN BANKS ARE PAYING A HIGH PRICE FOR SERBIAN ACQUISITIONS, AND THEY ARE EXPANDING RAPIDLY TO GENERATE A RETURN ON THESE INVESTMENTS. BANK CREDIT TO HOUSEHOLDS ROSE IN 2005 BY 76 PERCENT IN REAL TERMS, REACHING USD 1.73 BILLION, OR 7 PERCENT OF GDP, WHICH IS 30 PERCENT OF TOTAL NON-GOVERNMENT BORROWING, ACCORDING TO NBS DATA. BY COMPARISON, THE PROPORTION OF HOUSEHOLD DEBT IN NON-GOVERNMENT BORROWING IN 2004 WAS 32.5 PERCENT IN HUNGARY, 32.7 PERCENT IN BULGARIA, AND IN CROATIA, 55 PERCENT. AT THE SAME TIME, HOUSEHOLD BORROWING, AS A PERCENTAGE OF 2004 GDP, WAS 13.1 PERCENT IN HUNGARY, 10 PERCENT IN BULGARIA, AND IN CROATIA, 31.5 PERCENT. (SOURCE: EBRD TRANSITION REPORT 2005).

4. DESPITE PROGRESSIVELY HARSHER CENTRAL BANK RESTRICTIONS AIMED AT CURBING THE GROWTH OF LENDING, CREDIT GROWTH ACCELERATED AT THE BEGINNING OF 2006. IN JANUARY AND FEBRUARY, HOUSEHOLD INDEBTEDNESS INCREASED BY 8.4 PERCENT, I.E. USD 145 MILLION. BY COMPARISON, IN THE SAME PERIOD OF 2005, HOUSEHOLD BORROWING INCREASED BY 3.6 PERCENT, I.E. USD 38 MILLION.

5. ALTHOUGH MUCH OF THE GROWTH OF RESERVE MONEY IS DRIVEN BY THE CENTRAL BANK'S EURO PURCHASES, NBS OFFICIALS ARE ESPECIALLY WORRIED BY FLOWS OF FOREIGN CAPITAL INTO COMMERCIAL BANKS. "WE WOULD WISH THAT BANKS DIRECT THEIR ENERGY TO THE COLLECTION OF DEPOSITS IN COUNTRY, AND NOT TO BORROWING FROM ABROAD," SAID VICE GOVERNOR DIANA DRAGUTINOVICH, WHO DIRECTS MONETARY POLICY, IN A RECENT INTERVIEW. "THAT'S WHY WE WANT, BY THESE MEASURES, TO LIMIT THE BORROWING OF BANKS, WITH THE GOAL THAT THEIR CREDIT ACTIVITY BE LIMITED, LET'S SAY, TO LAST YEAR'S LEVEL."

6. IN 2005, BANKS' FOREIGN LIABILITIES INCREASED BY 78 PERCENT, OR USD 1.4 BILLION, TO USD 2.5 BILLION. FOREIGN BANKS, DETERMINED TO MAKE THEIR NEW INVESTMENTS PAY, CAN BORROW FROM OFFSHORE PARENTS CHEAPLY, SAY AT 4-5 PERCENT, AND LEND AT RATES OF 12-16 PERCENT, ON FEE-HEAVY, EURO-LINKED RETAIL CREDITS. MARGINS ARE LUCRATIVE, WITH SPREADS NOW DOWN TO PERHAPS 10 PERCENTAGE POINTS, FROM 13-15 PERCENT LAST YEAR, ACCORDING TO THE NBS.

7. RISING DEPOSITS CONTRIBUTED EQUALLY TO ADDITIONAL LIQUIDITY. HARD CURRENCY DEPOSITS LAST YEAR INCREASED BY 50.6 PERCENT TO USD 3.7 BILLION. DINAR SAVINGS DEPOSITS WERE UP BY 35 PERCENT TO 0.7 BILLION

(EXCLUDING CURRENT ACCOUNTS). EURO DEPOSIT RATES RANGE FROM 1 TO 5 PERCENT, DEPENDING ON MATURITY, LEAVING AMPLE ROOM FOR PROFIT AS THE BANKS RECYCLE THEM INTO LENDING. (NOTE: BANKERS SAY THAT RATES OFTEN ARE LOWER IN THE CORPORATE SECTOR, WHERE COMPETITION IS GREATER AND BORROWERS, MORE PRICE-CONSCIOUS.)

CENTRAL BANK FIGHTS TO KEEP CONTROL

18. THE INTERNATIONAL MONETARY FUND, IN ITS FINANCIAL SYSTEM STABILITY ASSESSMENT, PUBLISHED IN MARCH, RAISED THE ALARM: "THERE ARE EMERGING SIGNS THAT THE RAPID PACE OF CREDIT GROWTH IS BEGINNING TO ERODE FINANCIAL STABILITY." THE REPORT NOTES THAT SERBIA HAS A LOWER RATIO OF BANK CREDIT TO GDP THAN MOST COMPARABLE COUNTRIES, BUT PROJECTS THAT THE CURRENT RATE OF GROWTH COULD PUSH SERBIA'S DEBT LEVELS HIGHER THAN REGIONAL AVERAGES WITHIN A FEW YEARS. THE IMF ASSESSMENT ALSO NOTED THAT LEVELS OF NON-PERFORMING LOANS ARE RISING.

19. THE IMF ALSO POINTED TO THE "HIGH LEVEL OF EUROIZATION" AND THE FACT THAT ALMOST ALL LENDING IS IN EUROS, WHICH EXPOSES BORROWERS (AND, THUS, INDIRECTLY THE CREDITORS AS WELL) TO "CONSIDERABLE FOREIGN CURRENCY RISKS." THE IMF ALSO SINGLED OUT REMAINING STATE-OWNED BANKS AS PARTICULARLY VULNERABLE, IN LIGHT OF THEIR WEAK BALANCE SHEETS AND MANAGEMENT. (NOTE: SERBIA'S FIFTH-LARGEST BANK, STATE-OWNED VOJVODJANSKA BANKA, IS BEING PRIVATISED NOW, AFTER WHICH KOMERCIALNA BANK WILL BE THE LAST STATE-CONTROLLED BANK AMONG THE 10 LARGEST.)

110. THE NATIONAL BANK INITIALLY WAS SLOW TO RESPOND TO FUND CONCERNS. DURING 2005, GOVERNOR JELASIC TALKED FREQUENTLY OF THE NEED TO LOWER RATES, ARGUING THAT BANKS' SPREADS WERE TOO HIGH. INDEED, REAL RATES IN THE CENTRAL BANK'S REPO OPERATION, A KEY TOOL FOR STERILIZING CAPITAL INFLOWS, WERE NEGATIVE AND DID NOT BEGIN RISING AGAIN UNTIL OCTOBER.

111. THE PROBLEM OF RAPID MONEY SUPPLY GROWTH - AND ACCOMPANYING INFLATION - HAS BEEN DEVELOPING THROUGH 2005. RESERVE MONEY ROSE BY 66.9 PERCENT, M1 BY 30.2 PERCENT, AND M3 BY 41.9 PERCENT. THIS TREND SLOWED ONLY AT THE BEGINNING OF 2006, MAINLY AS A RESULT OF SEASONAL FACTORS. THIS GROWTH WAS REFLECTED IN THE RISE OF INFLATION TO 17.7 PERCENT, FROM 13.4 PERCENT IN 2004. DRAGUTINOVICH TOLD ECON CHIEF THAT THE NATIONAL BANK FINDS A HIGH CORRELATION BETWEEN THE GROWTH OF BROAD MONEY - M3 - AND INFLATION. SHE SAYS BROAD MONEY IS THE KEY MONETARY TARGET.

112. THE IMPACT ON THE CURRENT ACCOUNT DEFICIT WAS LESS APPARENT, AS THE GAP NARROWED FROM 12.6 PERCENT IN 2004 TO 8.6 PERCENT OF GDP IN 2005. THIS RELATIVE SUCCESS WAS DUE IN PART TO THE NATIONAL BANK'S DETERMINATION TO KEEP THE DINAR ROUGHLY STABLE AS A WAY OF DAMPING INFLATION EXPECTATIONS. BUT THE BANK AVOIDED NOMINAL APPRECIATION OF THE DINAR - AND, IN THEORY, HIGHER IMPORTS - ONLY BY BUYING UP EUROS AT A BRISK PACE. DESPITE NBS INTERVENTION IN THE FOREIGN EXCHANGE MARKET, THE DINAR DEPRECIATED RELATIVE TO THE EURO 8.1 PERCENT IN NOMINAL TERMS OVER 2005, BUT IT APPRECIATED 9.6 PERCENT IN REAL TERMS.

113. UNDER PRESSURE FROM THE FUND, THE NATIONAL BANK TIGHTENED MONETARY POLICY STEADILY THROUGHOUT THE SECOND HALF OF 2005. ITS APPROACH COMBINED BOTH STANDARD OPEN MARKET OPERATIONS, SEEKING TO WITHDRAW DINAR LIQUIDITY THROUGH ITS REPO OPERATIONS, AND A STEADY RAMPING UP OF SO-CALLED "RESERVE" REQUIREMENTS, WHICH FUNCTION IN MANY RESPECTS AS INDIRECT CAPITAL CONTROLS.

114. TO INCREASE THE PRESSURE ON BANKS AND THUS DECREASE THE SUPPLY OF CONSUMER CREDIT, THE NBS IMPLEMENTED THE FOLLOWING MEASURES OVER 2005, IN SEVERAL STEPS:
-- THE REQUIRED RESERVE FOR FOREIGN CURRENCY DEPOSITS WAS GRADUALLY INCREASED FROM 21 PERCENT TO 38 PERCENT;
-- THE BASE FOR REQUIRED RESERVES WAS BROADENED BY INCLUDING DINAR DEPOSITS THAT ARE INDEXED TO A HARD CURRENCY;
-- A RESERVE REQUIREMENT ON BORROWING FROM ABROAD WAS INTRODUCED AND INCREASED FROM 7 TO 38 PERCENT;
-- LEASING ALSO WAS TARGETED WITH AN OBLIGATORY RESERVE OF 10 PERCENT OF BORROWING FROM ABROAD.

115. THE NATIONAL BANK HAS CONSISTENTLY TRIED TO BROADEN USE OF THE DINAR, EVEN ISSUING RETAIL SAVINGS BONDS DIRECTLY TO CONSUMERS TO BOOST DINAR DEPOSIT RATES. IT DECREASED THE RESERVE REQUIREMENT ON DINAR DEPOSITS TO 18 PERCENT, VICE 40 PERCENT FOR FOREIGN CURRENCY DEPOSITS. NONETHELESS, EURO DEPOSITS REACHED 98 PERCENT OF TOTAL SAVINGS AT THE END OF 2005, UP FROM 97 PERCENT AT THE END OF 2004. (DINARS MAINLY ARE HELD ONLY IN CURRENT ACCOUNTS, FOR PAYMENT PURPOSES.)

16. DESPITE THE NATIONAL BANK'S EFFORTS, INTEREST RATES ON HOUSEHOLD BORROWING REMAINED LARGELY UNCHANGED, DUE TO A NUMBER OF FACTORS. MARGINS ON SUCH LENDING ALREADY WERE HIGH, AND COMPETITION AMONG THE GROWING NUMBER OF FOREIGN BANKS TENDED TO KEEP RATES DOWN. AT THE SAME TIME, BANKS HAVE FOUND LESS TRANSPARENT WAYS TO RAISE EFFECTIVE INTEREST RATES, THROUGH FEES AND DOWN PAYMENT REQUIREMENTS. AND, AS RAFFEISEN BANK CEO OLIVER ROEGEL NOTES, THE PENT-UP DEMAND FOR CONSUMER CREDIT IS SO GREAT THAT BORROWERS APPEAR TO BE READY TO PAY ANY INTEREST RATE.

17. THE CENTRAL BANK'S NEW MEASURES APPEAR TO HAVE HAD LITTLE IMPACT ON CREDIT GROWTH, WHICH CONTINUED TO ACCELERATE THROUGH THE SECOND HALF OF 2005. DOMESTIC CREDIT WAS UP 15.3 PERCENT IN THE FIRST HALF, BUT SURGED BY 24.3 PERCENT IN THE SECOND. THE NATIONAL BANK'S GROSS RESERVES WERE UP 72 PERCENT ON THE YEAR, TO USD 6.1 BILLION, LARGELY DRIVEN BY THE FLOW OF MONEY FROM EXCHANGE HOUSES TO THE CENTRAL BANK.

18. AT THE SAME TIME, THE NATIONAL BANK WAS FIGHTING INCREASED CAPITAL INFLOWS. AS MENTIONED ABOVE, BANKS INCREASED THEIR BORROWING, OFTEN FROM THEIR FOREIGN PARENTS, BY USD 1.4 BILLION, TO USD 2.5 BILLION AT THE END OF 2005, I.E. 10 PERCENT OF GDP. THE BANK REACTED BY FIRST IMPOSING "RESERVE REQUIREMENTS" ON SUCH BORROWING, AND THEN STEADILY INCREASING THE RATE TO EQUALIZE IT WITH THE RATE ON HARD CURRENCY DEPOSITS. BANKERS POINT OUT THAT SUCH RESERVE REQUIREMENTS ARE NOT NEEDED ON INTRABANK LOANS, SINCE A PARENT BANK IS NOT LIKELY TO PULL A LOAN AND PUT PRESSURE ON ITS SUBSIDIARY, IN THE SAME WAY THAT DEPOSITORS EN MASSE CAN WITHDRAW DEPOSITS.

19. AGAINST THESE HEAVY CAPITAL INFLOWS, THE NBS WAS ABLE TO STERILIZE, OR WITHDRAW FROM CIRCULATION, THROUGH ITS OPEN MARKET REPO OPERATIONS, ONLY DINARS WORTH USD 0.443 BILLION DOLLARS. THE VOLUME OF REPO OPERATIONS INCREASED GRADUALLY OVER THE YEAR, IN PART BECAUSE IT WAS A NEW INSTRUMENT FOR THE CENTRAL BANK, AND IN PART BECAUSE THE BANK WAS RELUCTANT TO PUSH UP RATES. INTEREST RATES VARIED FROM 20 PERCENT AT THE VERY BEGINNING OF THE YEAR, TO THEIR LOWESTS IN JUNE AT 13.5 PERCENT, AND THEN GRADUALLY RISING TO 20 PERCENT BY YEAR-END. THE LATEST RATE IS ABOUT 24 PERCENT.

20. COMPARED TO THE SIZE OF THE INFLOWS, THIS IMPACT CLEARLY WAS MINOR, FORCING THE BANK TO RESORT TO RESERVE REQUIREMENTS. AND AS EUROIZATION INCREASES, THE CENTRAL BANK'S ABILITY TO AFFECT THE MONEY SUPPLY THROUGH A DINAR INSTRUMENT BECOMES PROGRESSIVELY WEAKER. BANK OFFICIALS SAY THEY WERE ABLE TO STERILIZE 87 PERCENT OF CAPITAL INFLOWS, BUT ABOUT 1.428 BILLION, OR THREE-QUARTERS, WAS WITHDRAWN VIA RESERVE REQUIREMENTS.

21. "A PARADOXICAL SITUATION IS CREATED," ECONOMIST STOJAN STAMENKOVIC POINTS OUT IN A RECENT ANALYSIS. "ON ONE HAND, THE BUSINESS BANKS, WITH THE GOAL OF CREATING EXTRA INCOME (ON THE BASIS OF THE DIFFERENCE BETWEEN THE INTEREST RATE ON DOMESTIC AND FOREIGN FINANCIAL MARKETS), TAKE CREDITS FROM OVERSEAS, AND THE CENTRAL BANK IS FORCED TO, THROUGH AN EXPENSIVE MECHANISM OF STERILIZATION, TO OFFSET THE EFFECT OF THESE CREDITS IN THE DOMESTIC FINANCIAL MARKET. THE EARNINGS BELONG TO THE BANKS, AND THE EXPENSE OF ANTI-INFLATION ACTION TO THE CENTRAL BANK.... SUCH A MONETARY POLICY IS VERY EXPENSIVE."

22. THE INEFFECTIVENESS OF MONETARY POLICY GOES BEYOND THE PROBLEM OF CAPITAL INFLOWS, STAMENKOVIC EXPLAINED TO ECON CHIEF. AS THE NBS WITHDRAWS DINAR LIQUIDITY THROUGH RESERVE REQUIREMENTS, REPO OPERATIONS, AND SAVINGS BONDS, HOUSEHOLDS OR FIRMS, WHICH HOLD MOST OF THEIR ASSETS IN FOREIGN CURRENCY, REACT BY SIMPLY CONVERTING MORE EURO TO DINAR. AND THE DUAL CURRENCY NATURE OF THE ECONOMY MAKES IT DIFFICULT FOR THE CENTRAL BANK TO MASTER THIS MECHANISM, SINCE CORPORATE AND RETAIL FOREIGN CURRENCY RESERVES ARE HIGHER THAN M1 MONEY SUPPLY.

23. THE BANK CLEARLY RECOGNIZES ITS DILEMMA. VICE GOVERNOR DRAGUTINOVICH, IN A RECENT PRESS INTERVIEW, SAID THAT THE HIGH RATES THE CENTRAL BANK PAYS IN THE REPO MARKET ARE IN FACT A MOTOR DRIVING BANKS TO BORROW MORE OVERSEAS. AND SHE NOTED THAT SOME CENTRAL BANK SECURITIES FOUND THEIR WAY, NOT INTO THE BANKS' PORTFOLIOS, BUT INTO THOSE OF OVERSEAS INVESTORS WHO ARE LOCKING IN AN INTEREST RATE PLAY, SAFEGUARDED BY THE CENTRAL BANK'S VIRTUAL PEG OF THE DINAR. ROEGL, OF

RAFFEISEN, CONFIRMED THAT SOME FOREIGN BANKS ARE ACTING ON BEHALF OF OVERSEAS SPECULATORS IN THE CENTRAL BANK'S REPO OPERATIONS.

124. "THE TIME IS, THEN, TO CONSIDER WHETHER THIS HIGH INTEREST RATE IN CONDITIONS OF A VERY LIBERAL INFLOW OF CAPITAL RAISES THE LEVEL OF FINANCIAL INSTABILITY," DRAGUTINOVIC SAID IN THE PRESS INTERVIEW.

CENTRAL BANK SIGNALS COMMITMENT, BUT RESISTANCE GROWS

125. THE NATIONAL BANK'S LATEST MEASURES, ANNOUNCED ON MARCH 31, RAISED THE RESERVE REQUIREMENT FROM 38 TO 40 PERCENT ON HARD CURRENCY DEPOSITS AND DINAR DEPOSITS INDEXED IN EURO. BANKS ALSO MUST ALLOCATE 20 PERCENT AS A RESERVE ON BORROWINGS BASED ON SUBORDINATED CAPITAL, WHILE THE RESERVE REQUIREMENT ON LEASING WAS RAISED TO 20 PERCENT, VICE 10 PERCENT.

126. GOVERNOR JELASIC, IN ANNOUNCING THE NEW RESTRICTIONS, SAID THAT THE NBS WANTS TO DECREASE INFLATIONARY PRESSURE BY WITHDRAWING AROUND 13.7 BILLION DINARS (5.5 PERCENT OF RESERVE MONEY FROM 2005) FROM BANKS' LIQUIDITY TO BRING THE MONEY SUPPLY DOWN TO THE LEVEL AT THE END OF LAST YEAR. HE ALSO WARNED THAT THERE IS MORE TO COME, THAT THE CENTRAL BANK WILL REACT TO FUTURE INFLATION BY INCREASING RATES ON REPO OPERATIONS, BY FURTHER BOOSTING REQUIRED RESERVES, BY ISSUING MORE SAVINGS BILLS AND THROUGH ENHANCED SUPERVISION OVER BANKS AND LEASING COMPANIES. HOWEVER, THE MARCH 31 MEASURES FOLLOWED CLOSE ON DATA THAT SHOWED MARCH INFLATION WAS ONLY 0.3 PERCENT, BRINGING THE INCREASE IN CONSUMER PRICES TO 2.2 PERCENT FOR THE FIRST QUARTER.

127. JELASIC TOLD ECON CHIEF ON APRIL 5 THAT THE NATIONAL BANK IS NOT FIXATED ON HITTING THE SINGLE DIGIT INFLATION TARGET FOR 2006, BUT RATHER IS FOCUSED ON MAINTAINING A DOWNWARD TREND. DRAGUTINOVICH CONFIRMED THAT THE BANK IS CONSIDERING EVEN TIGHTER RESTRICTIONS, SUCH AS MARGINAL RESERVE REQUIREMENTS ON NEW BORROWINGS ABROAD, IF INFLATION NUMBERS ARE ALARMING.

128. THE MARCH MEASURES FOLLOWED CLOSE ON THE HEELS OF MORE RESTRICTIONS ANNOUNCED IN FEBRUARY, WHEN THE NBS IMPOSED PROVISIONING MEASURES AIMED AT LIMITING HOUSEHOLD BORROWING. THESE MEASURES REQUIRE THAT BANKS HOLD A DEPOSIT OF 20 PERCENT ON ALL CONSUMER CREDITS AND THAT THE MONTHLY INSTALLMENT NOT EXCEED 30 PERCENT OF HOUSEHOLD INCOME. IN EVENT OF NON-COMPLIANCE, BANKS ARE REQUIRED TO SET ASIDE A MANDATORY RESERVE OF 100 PERCENT OF THE LOAN.

129. THE NATIONAL BANK'S CONTINUED DETERMINATION TO CLAMP DOWN ON CREDIT GROWTH - AND BRING INFLATION UNDER CONTROL - HAS PROVOKED INCREASING OPPOSITION. FOR INSTANCE, AT A PUBLIC MEETING OF THE FOREIGN INVESTOR'S COUNCIL ON MARCH 15, MILAN PARAVODIC, MINISTER FOR INTERNATIONAL ECONOMIC AFFAIRS, OPENLY CRITICIZED THE CENTRAL BANK'S LATEST RESTRICTIONS, ARGUING THAT EASIER ACCESS TO CREDIT WAS NECESSARY FOR DEVELOPMENT.

130. GORAN PITIC, HEAD OF SOCIETE GENERALE BANK, SAID AT THE SAME EVENT THAT THE CENTRAL BANK'S POLICIES HAD BEEN UNSUCCESSFUL, SINCE CREDIT GROWTH CONTINUED AND INFLATION PERSISTED. THIS SHOWS THAT HIGH INFLATION IS DRIVEN NOT JUST BY MONETARY DEVELOPMENTS, PITIC SAID, AND WARNED THAT A FURTHER INCREASE OF OBLIGATORY RESERVES OR INTRODUCTION OF NON-MARKET MEASURES WOULD INCREASE LENDING RATES. ALEXANDER PICKER, THE HEAD OF AUSTRO-GERMAN HVB BANK, WAS EVEN SHARPER, ACCUSING THE BANK OF USING POPULIST RHETORIC IN ITS CAMPAIGN AGAINST LENDING PRACTICES, AND OF EMPLOYING DISCRIMINATORY POLICIES IN ITS USE OF AUDITS. (NOTE: SOME BANKING SCENE OBSERVERS SAY THE FOREIGN BANKS BELIEVE THE CENTRAL BANK TO BE UNDULY PROTECTIVE OF THE SERBIAN BANKS; FOR INSTANCE, IT IS COMMONLY SAID THAT CENTRAL BANK AUDITORS SPEND ALMOST ALL THEIR TIME IN THE FOREIGN BANKS.)

131. ROEGL, OF RAIFFEISEN, ELABORATED ON PICKER'S CHARGES IN APRIL 3. HE SAID THAT THE NATIONAL BANK IS USING AUDITS TO IMPOSE CREDIT LIMITS ON THE LARGEST BANKS IN AN ATTEMPT TO RESTRAIN LENDING. RAIFFEISEN, THE MARKET LEADER, HAS WORKED HARD TO APPLY GOOD RISK MANAGEMENT, ROEGL SAID, BUT CENTRAL BANK AUDITORS SIMPLY JUDGED ITS PRACTICES INADEQUATE AND IMPOSED QUANTITATIVE LIMITS ON ITS CREDIT ISSUANCE. IN ADDITION, THEY INSIST ON USING PROVISIONING STANDARDS THAT EXCEED INTERNATIONAL STANDARDS. THE RESULT IS SIMPLY TO SLOW RAIFFEISEN'S GROWTH, HE SAID. (NOTE: THE IMF RESIDENT REPRESENTATIVE RECENTLY TOLD ECON CHIEF THAT THE CENTRAL BANK HAD AGREED TO STOP IMPOSING SUCH CREDIT LIMITS.)

132. THE BANK'S MEASURES MAY ALSO HAVE UNINTENDED EFFECTS, ROEGL WARNED. BY INCREASING BANKS' FUNDING COSTS THROUGH RESERVE REQUIREMENTS, THE NATIONAL BANK MAY PUSH COMMERCIAL BANKS TO FOCUS EVEN MORE ON CONSUMER LENDING, WHERE THE MARGINS ARE HIGHER. THIS TREND IS COMPOUNDED BY THE ABILITY OF THE BEST CORPORATE CUSTOMERS TO BORROW OVERSEAS DIRECTLY, IN WHICH CASE CENTRAL BANK CREDIT CONTROLS ARE EVADED COMPLETELY.

THE OUTLOOK AND RISKS

133. JELASIC NEVER PASSES UP AN OPPORTUNITY TO REMIND THE PUBLIC THAT THE CENTRAL BANK CANNOT CONTROL INFLATION ON ITS OWN, THAT FISCAL POLICY AND STRUCTURAL REFORM MUST PLAY THEIR PART. STAMENKOVICH ECHOES THIS POINT, ARGUING THAT THE BURST IN INFLATION SEEN IN 2005 IN PART WAS CAUSED BY THE FINANCE MINISTRY. HE POINTS OUT THAT THE BUDGET REBALANCE CARRIED OUT IN MID-2005, BY CHANGING METHODOLOGY, OBSCURED WHAT IN FACT WAS A SIGNIFICANT INCREASE IN SPENDING OF 0.7 PERCENT OF GDP.

134. FISCAL RISKS MAY ARISE AGAIN THIS YEAR, STAMENKOVICH SAID. VAT REVENUES FOR JANUARY AND FEBRUARY ARE 3 PERCENT BELOW PROJECTION, AND THE GOVERNMENT WILL BE TEMPTED TO MAKE UP THE DIFFERENCE FROM PRIVATIZATION REVENUES, WHICH WOULD HAVE AN INFLATIONARY IMPACT. INDEED, JELASIC, AT HIS MARCH 31 PRESS CONFERENCE, ALSO POINTED TO THIS ISSUE, CLAIMING THAT THE GOVERNMENT ALREADY IS FINANCING SOME PROJECTS FROM PRIVATIZATION REVENUES. AND THE FINANCE MINISTER HAS BEEN PUBLICLY PROMOTING A 1 BILLION EURO (5 PERCENT OF GDP) INVESTMENT PLAN.

135. THE RISE OF NON-PERFORMING LOANS (NPL) ALSO POSES RISKS, A POINT RAISED BY THE IMF IN ITS MARCH ASSESSMENT. "THE APPARENT INCREASE IN THE NPL TO TOTAL LOAN RATIOS OF MOST FOREIGN BANKS DURING 2005 COULD BE AN EARLY SIGN OF A WORSENING OF FINANCIAL STABILITY," THE IMF REPORTED. THE BAD LOAN RATE AT FOREIGN BANKS INCREASED FROM 3.9 PERCENT IN 2003 TO 10.7 PERCENT IN SEPTEMBER 2005. MORE RECENT DATA SHOWS THAT NON-PERFORMING LOANS ARE UP, FROM THE SECOND QUARTER OF 2005 THROUGH THE FOURTH QUARTER, FROM 8.79 TO 14.45 TO 16 PERCENT FOR FOREIGN BANKS, FROM 38.9 TO 29.5 TO 37.7 PERCENT FOR STATE-CONTROLLED BANKS, AND FROM 21.13 TO 20.34 TO 46.63 PERCENT FOR DOMESTIC PRIVATE BANKS. HOWEVER, BANKERS CONSISTENTLY SAY THAT CONSUMER CREDITS PRESENT FEW NON-PAYMENT PROBLEMS, A FACT THAT ROEGL RECENTLY CONFIRMED.

136. STAMENKOVICH, IN A RECENT PAPER WITH SEVERAL OTHER ECONOMISTS, WARNS THAT THE CURRENT POLICY THREATENS TO INCREASE INTEREST RATES, RAISE THE RISK OF RECESSION, AND AT THE SAME TIME INCREASE CAPITAL INFLOWS. SUCH INFLOWS LIKELY WILL LEAD TO SOME APPRECIATION OF THE DINAR - DESPITE THE CENTRAL BANK'S EFFORTS TO AVOID THIS OUTCOME - JEOPARDIZING EXPORT COMPETITIVENESS. HIS PREFERENCE WOULD BE FULL LIBERALIZATION OF THE CURRENCY MARKET AND FULL LIBERALIZATION OF THE CAPITAL MARKET. CAPITAL INFLOWS COULD, TO SOME EXTENT, BE OFFSET BY CAPITAL OUTFLOWS AS SERBS ARE PERMITTED TO BUY OFFSHORE ASSETS. HE NOTES THAT A HIGH CAPITAL INFLOW CAN CREATE AN ASSET BALLOON IN THE DOMESTIC REAL ESTATE MARKET, GIVEN THE SHORTAGE OF INVESTMENT OPTIONS.

137. DRAGUTINOVICH TOLD ECON CHIEF THAT THE NATIONAL BANK IS PLANNING TO LIBERALIZE THE EXCHANGE MARKET THIS YEAR. IT WILL WITHDRAW FROM ITS ROLE AS EXCLUSIVE PURCHASER OF FOREIGN EXCHANGE FROM EXCHANGE HOUSES AND ALLOW THE BANKS TO TAKE OVER THIS ACTIVITY, REDUCING ITS ROLE IN EXCHANGE RATE FORMATION. (NOTE: THE CENTRAL BANK ALSO DICTATES RATES TO THE EXCHANGE HOUSES.) INDEED, SHE SAID THAT THE BANKS INCREASINGLY TRADE FOREIGN CURRENCY AMONG THEMSELVES, ALTHOUGH IT IS NOT A FORMAL MARKET. AT THE SAME TIME, SHE WAS NON-COMMITTAL ON THE ISSUE OF CAPITAL OUTFLOWS.

138. ON THE PLUS SIDE, JELASIC'S POSITION AT THE NATIONAL BANK APPEARS TO BE SOMEWHAT STRONGER. HIS FIVE-YEAR TERM ENDS IN 2009, MORE THAN A YEAR AFTER THE KOSTUNICA GOVERNMENT MUST FACE ELECTIONS. HE APPEARS TO HAVE SURVIVED THE "SUITCASE" SCANDAL, WHICH RESULTED IN THE ARREST OF THE VICE GOVERNOR FOR THE BANKING SECTOR ON BRIBERY CHARGES. THE VICE GOVERNOR RECENTLY WAS RELEASED FROM PRE-TRIAL CONFINEMENT, AND MANY BELIEVE THAT THE ENTIRE EPISODE WAS AN EFFORT TO PRESSURE THE CENTRAL BANK OVER LICENSING ISSUES.

139. AT THE SAME TIME, THE CENTRAL BANK AT TIMES APPEARS A BIT LOST. FOR INSTANCE, DRAGUTINOVICH KNEW NOTHING ABOUT THE ROLE THAT INSURANCE COMPANIES PLAY IN INSURING CONSUMER CREDIT, ALTHOUGH THIS PRACTICE ALMOST CERTAINLY IS SPURRING RETAIL LENDING. BANKS, FOR A

MODEST PREMIUM, CAN OFFLOAD THEIR CREDIT AND FOREIGN EXCHANGE RISK ON THE STATE-OWNED - AND FEE-HUNGRY - STATE-OWNED INSURANCE COMPANIES. JELASIC IS AWARE OF THE MORAL HAZARD INVOLVED, BUT APPARENTLY HAS NOT BROUGHT THIS ISSUE INTO MONETARY POLICY DISCUSSIONS. (WE RECENTLY WERE INFORMED BY THE MAIN PLAYER, DUNAV INSURANCE, THAT THEY HAVE CEASED WRITING SUCH COVERAGE.)

140. COMMENT: CAPITAL INFLOWS AND THE RAPID CHANGES IN SERBIA'S BANKING SECTOR POSE A CHALLENGE TO THE CENTRAL BANK. ITS RESPONSE HAS BEEN CONVENTIONAL, AND EFFECTIVE IN THE SHORT TERM, ALTHOUGH THE BANK IS BUILDING A SIGNIFICANT RISK IN THE MAGNITUDE OF ITS STERILIZATION PROGRAM. THE CZECH REPUBLIC BUILT A LARGE STERILIZATION POSITION ONLY TO SEE THE FOREIGN MONEY HEAD FOR THE DOOR IN MAY 1997, LEADING TO A 10 PERCENT DEVALUATION OF THE KORUNA. MOST AGREE THAT THE BANK SHOULD BE SELECTIVE IN TARGETING CONSUMER CREDIT GROWTH THROUGH PRUDENTIAL MEASURES, RATHER THAN RISK DRAINING CREDIT FROM THE ENTERPRISE SECTOR AND SLOWING GROWTH. A LIBERAL STANCE ON CAPITAL OUTFLOWS WOULD BE SENSIBLE, AND THE NEW FOREIGN EXCHANGE LAW MAY PROVIDE AN OPPORTUNITY FOR PROGRESS. IN ADDITION, WHILE PROSPECTS FOR A NEW IMF AGREEMENT AFTER THE MONTENEGRO REFERENDUM ARE UNCERTAIN, THE IMF RESIDENT REPRESENTATIVE SAYS THAT THE FUND IS BRINGING IN AN EXPERIENCED MONETARY ECONOMIST TO WORK AS AN ADVISER IN THE NATIONAL BANK. THE TRANSITION TO A MORE MARKET-DRIVEN EXCHANGE RATE WILL BE A MAJOR CHALLENGE FOR THE CENTRAL BANK, ESPECIALLY AS THE DINAR APPRECIATES. END COMMENT.

POLT